

**MINUTES OF THE REGULAR MEETING OF THE
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**HELD ON
Friday, January 19, 2001
8:30 a.m., M.S.T.**

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room of the ASRS office at 3300 North Central Avenue, Phoenix, Arizona 85067-3910. Dr. Chuck Essigs, Chairman, Arizona State Retirement System Board, called the meeting to order at 8:33 a.m., M.S.T. The meeting was teleconferenced to the ASRS Tucson office, 7660 East Broadway Boulevard, Suite 108, Tucson, Arizona 85710-3776.

1. Call to Order; Roll Call

Present: Dr. Chuck Essigs, Chairman
Mr. Jim Bruner, Vice Chairman
Dr. Merlin DuVal
Ms. Bonnie Gonzalez (via teleconference)
Mr. Jim Jenkins
Mr. Alan Maguire
Mr. Norman Miller
Mr. Karl Polen
Mr. Ray Rottas

A quorum was present for the purpose of conducting business.

2. Approval of Minutes of the November 17, 2000 Regular Meeting of ASRS Board

Motion: Dr. Merlin DuVal moved to approve the minutes of the November 17, 2000 regular meeting of the ASRS Board.

Mr. Ray Rottas seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, 0 excused, the motion was approved.

3. Board Approval of Consent Schedule

Motion: Dr. Merlin DuVal moved that the ASRS Board approve the Retirements, Refunds, and Death Benefits; System Transfers; Representative Payee Request; and the Applications and Agreements between the ASRS and the following Employer:

- Project YES Middle School, LLC

Mr. Jim Bruner seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, 0 excused, the motion was approved.

4. Presentation, Discussion and Appropriate Action Regarding a Disposition Strategy for the Bank One Commercial Mortgage Portfolio

Mr. Paul Matson, Chief Investment Officer (CIO), gave a brief background on the Bank One Commercial Mortgage Portfolio. The Board had previously directed staff to stop funding the portfolio and to identify an appropriate course of action to liquidate it. Mr. Matson outlined the staff-recommended process to dispose of the portfolio:

- Issue a Request for Proposal (RFP) to hire a third-party firm that would market the mortgage portfolio to public and private companies such as banks, insurance companies and pension funds that may be interested in the portfolio, and then solicit bids from those companies.
- Create a RFP Evaluation Committee to facilitate the evaluation and award of the contract.
- Authorization to pay costs to the RFP award recipient and third-party vendors related to the disposition of the portfolio.
- Authorization to pay a service/success fee to the RFP award recipient upon successful disposition of the portfolio.
- Authorization for the CIO to accept or reject bids upon discussion with the RFP Evaluation Committee Chair, the Investment Review Board Committee (IRBC) Chair, the Board Chair and the Director.

Mr. Norman Miller suggested that during the bid process local banks, which may deem the portfolio more valuable than national companies and therefore be more likely to pay a premium for it, be an initial target market.

Motion: Mr. Miller moved to direct the ASRS staff to create and issue a Request for Proposal from firms to develop a strategy and process for the disposition of the commercial mortgage portfolio, with the intermediate step that the firm awarded the contract market the portfolio to Arizona companies before marketing it nationwide.

Dr. DuVal seconded the motion.

Mr. Ray Rottas expressed concern about the RFP Evaluation Committee awarding the contract rather than the full Board. Mr. Matson answered that the Evaluation Committee could recommend which firm to award the contract to the full Board. Once that firm is in place and begins the process of selling the portfolio, it may be problematic to come back to the Board with the bids for the portfolio because generally bids are only good for a matter of days. The Board would have to meet within a few days of the bid opening to ensure a prompt response to any bids. Mr. Rottas reiterated that the full Board should approve the contract with the firm and the bids for the portfolio.

Mr. Jim Bruner stated he believes the portfolio should be marketed simultaneously to both local and national companies. Mr. Miller clarified that the local market should not be overlooked so that the system does not miss the opportunity for potential cost savings and premiums.

Mr. Bruner expressed concern that reimbursement costs for the firm facilitating the sale could potentially be open-ended. Mr. Matson explained the firm will be reimbursed, up to a certain limit, for the cost of marketing the portfolio up until the time of sale. If the firm deems it necessary to exceed those limits, prior ASRS staff approval would be required. Once a sale is approved by the Board, the firm will also be paid a fee based on a percent of the proceeds.

Motion: Mr. Jim Jenkins moved to appoint Mr. Norman Miller, Mr. Jim Bruner and Mr. Alan Maguire to the RFP Evaluation Committee.

Dr. Merlin DuVal seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, 0 excused, the motion was approved.

Motion: Mr. Alan Maguire moved to direct the ASRS staff to create and issue a Request for Proposal from firms to develop a strategy and process for the disposition of the commercial mortgage portfolio and to bring a recommendation from the RFP Evaluation Committee for the award to the Board.

Mr. Ray Rottas seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, 0 excused, the motion was approved.

Motion: Mr. Jim Jenkins moved that the bids for the Commercial Mortgage Portfolio be brought, in a prompt manner, to the Board for a decision, and that the portfolio be marketed to all parties, both within and outside of Arizona, simultaneously.

Mr. Ray Rottas seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, 0 excused, the motion was approved.

5. Presentation, Discussion and Appropriate Action Regarding Legislative Topics

Mr. Norman Miller noted that this legislative session will be extraordinarily busy for the ASRS as legislators take up health care, pension benefits and other issues for state employees and retirees that may have been overlooked in past sessions.

Mr. Tom Augherton, Deputy Director External Operations, discussed the restructuring of the House and Senate committees that deal with retirement issues. There are over 30 introduced bills addressing retirement issues, but currently only about 10 that directly affect the ASRS. The House Retirement & Government Operations Committee is chaired by Representative Debra Brimhall, who is moving bills quickly out of the committee in order to get them to the Appropriations Committee and over to the Senate. Most of members of the committee are freshmen representatives who, because of the hurried pace, are currently only briefed by committee staff and are not receiving the analysis by the ASRS actuarial. The Senate Finance Committee is chaired by Senator Scott Bundgaard. There is not a Retirement Subcommittee as there has been in the past. Senator Ed Cirillo, who sits on the Finance Committee, will continue to be a point person for retirement issues in the Senate.

Mr. Tom Finnerty, ASRS Legislative Liaison, reported on the status of current legislation:

- **HB 2008** PSPRS; membership; park rangers
By Representative Gray
A bill which removes park rangers who are certified peace officers from the ASRS and allows them to participate in the Public Safety Personnel Retirement System (PSPRS).
- **HB 2038** reviser's technical corrections; 2001
By Representatives Brimhall/Hatch-Miller
Introduced every year to incorporate Legislative Council's recommendations for correcting strictly technical problems resulting from legislation passed during the previous legislative session.
- **HB 2049** ASRS; benefits; 2.5 multiplier
By Representative Brimhall
Increases the multiplier in the formula from 2.1% to 2.5%, which would increase the contribution rate from 2.00% to 6.45% for employers and employees beginning in 2003.
- **HB 2050** ASRS; retirees; return to work
By Representative Brimhall

Extends the return to work provisions, currently only available to teachers, to all ASRS retirees so that they can go back to work on a full-time basis and still be eligible for retirement benefits.

- **SB 1012** PSPRS; EORP; tax equity; benefits

By Senator Cirillo

As a result of a federal court case, which decided that federal retired employees have to be treated the same as state retired employees, in 1989 legislation was passed that increased the taxation on Arizona retirement income. At that time, the state granted a 3% benefit increase to PSPRS members to offset the tax. PSPRS has received similar equity on several different occasions since. The ASRS members have not had a tax equity bill since 1990. Senator Daniels is expected to offer an amendment.

Mr. Finnerty also highlighted bills that will be before the committees in the coming weeks:

- **HB 2159** state employees; retirees; health insurance

By Representative Brimhall

Requires that the Department of Administration (DOA) and the ASRS only enter into statewide contracts to procure health insurance.

- **HB 2164** retirees; health insurance subsidies

By Representative Brimhall

This bill would represent a major increase in the retiree health insurance premium to the maximum allowed by the IRS and would provide a special benefit increase for rural members. The impact of an increase is being studied by the ASRS actuary.

- **HB 2169** supplemental defined contribution plans

By Representative Brimhall

Repeals provisions of the alternate defined contribution retirement programs established in 1998 and replaces them with a supplemental defined contribution program that allows an employer match to employee contributions.

Dr. Merlin DuVal commented that if HB 2159 passes, it may preclude the state from receiving any bids from vendors. He suggested that, in addition to obtaining impact estimates from the ASRS actuary, health insurance companies should testify as to the impact the bill will have on their willingness to bid. Mr. Miller noted that some of the companies are aware of the bill and that there is a coalition developing in opposition to the bill.

Mr. Augherton noted that Senator Marsha Arzberger has introduced SB 1106, which will establish a study committee to look at the health insurance problem. The Senator also introduced SB 1107, which proposes a 36-month bump in the health insurance premium to provide time for the study and for appropriate legislative response. Mr. Finnerty noted that SB 1107 also has a provision that would allow members in rural areas to decline the ASRS health insurance and receive an increase in their retirement benefit equal to the subsidy. This would give rural members the option of finding their own carriers, but it may have an adverse effect on the ASRS premium costs.

Dr. DuVal observed that in the last legislative session, a nine-person task force was created to examine whether the state of Arizona is in a position to develop a self-funded health insurance program that will cover everyone in the state. That task force has met several times. Mr. LeRoy Gilbertson, Director, commented that Senator Arzberger is aware of the task force and has asked for additional information about its efforts.

Mr. Norman Miller requested that the Weekly Legislative Report be comprehensive and that it indicate the bills that are new or that will be heard in scheduled committee meetings.

Mr. Finnerty discussed some of the technical and administrative changes in the ASRS 2001 Omnibus Bill. Mr. Paul Matson explained language amending Section 38.719 B.2 exempting from the 5% limit certain mortgage-related securities backed by federal agencies. From a credit-perspective, it is prudent not to have more than 5% of assets in a single issuer. However, in the bond market, there is one federal agency, Fannie Mae, that is a fundamentally large component of the bond market. Because Fannie Mae is the issuer of so many bonds, it prevents the ASRS from diversifying the portfolio against mortgage-backed securities because the assets are constantly coming up to the 5% limit on a single issuer. The manager must then sell, which prohibits the fund from reaching asset allocation targets. Language in the ASRS Omnibus Bill keeps the 5% constraint except for federal-guaranteed agencies and mortgage-backed securities.

Mr. LeRoy Gilbertson discussed provisions and potential impact of draft legislation including: transition from Projected Unit Credit (PUC) to Entry Age Normal (EAN) over 10 years with an amortization period of 30 years; an increase in the retiree health insurance supplement in rural areas and to the maximum of IRS guidelines; a graded multiplier; an "Employer Option" Deferred Retirement Option Program (DROP); a Partial Lump Sum Option Program; a Supplemental Defined Contribution 401(a) Program; and an incremental supplemental payment for retirees in addition to the permanent benefit increase, based on number of years of service.

Mr. Alan Maguire stated support for the transition to EAN and the extended amortization period, the DROP program and the idea of the 401(a). He expressed concern about the graded multiplier. He believes it targets the retention of long-term employees and that the DROP program is a better solution for encouraging newer employees to stay in state and local positions. He stated that, in his opinion, the graded multiplier is a very expensive solution to the wrong problem, and he will so express to various legislators and the governor's office. Mr. Maguire also cautioned against differentiating the health insurance supplement in different areas of the state or making any short-term changes because of the effect it may have on a subsequent benefit. Instead, the state should look at health insurance as a part of a retiree's cost of living rather than as a single budget item.

Mr. Jim Jenkins agreed that state and local government need to look at the turnover rate and encourage long-term service by rewarding people with some sort of enhanced retirement benefit, such as the graded multiplier would offer.

Mr. Miller requested that the External Relations and Legislative Board Committee meet each week to stay on top of the movement of the various legislation in order to ensure that the long-term goals and policy objectives of the ASRS are not compromised by colliding legislation.

Mr. Rottas observed that because of the economic landscape, the fund will not have the returns it has had in recent years. The ASRS should be careful about its commitments, especially those that are short-term solutions that may have a long-term impact.

Mr. Norman Miller left at 9:52 a.m.

Mr. Gilbertson reported that the Joint Legislative Budget Committee (JLBC) approved 99% of the ASRS Budget and Information Technology Request upon approval of the Government Information Technology Agency, which was meeting this same time and day. Dr. Essigs commended Ms. Bonnie Gonzalez, as chair of the Budget Committee, and staff for their work on the proposal, which requested a significant increase in agency funding. Ms. Gonzalez commended the staff for their hard work and efforts.

Mr. Alan Maguire left at 9:55 a.m.

6. Presentation, Discussion and Appropriate Action Regarding the Extension of Investment Consultant Contracts

Mr. Jim Bruner reported that the IRBC committee met on January 2, 2001 and reviewed the five-year investment consultant contracts with Mercer Investment Consulting, Inc. and Callan Associates. The committee agreed to continue the contracts within the terms of the existing contract with the appropriate increases.

Motion: Mr. Jim Bruner moved to approve the extension for the third year of a potential five-year contract of Mercer Investment Consulting, Inc., to provide performance measurement and monthly presentation services for the ASRS, as presented by the ASRS Investment Review Board Committee, at the fee schedule as outlined below:

<i>Investment Consultant Functions</i>	<i>Mercer Investment Fees</i>
Performance Measurements & Monthly Presentations	\$148,400 Per Year

and to approve the extension for a third year of a potential five-year contract of both Mercer Investment Consulting, Inc., and Callan Associates, Inc., to provide other investment related services on an as needed basis, at the fee schedule as outlined below:

<i>Investment Consultant Functions</i>	<i>Mercer Investment Fees</i>
Evaluation of Potential Investment Managers	\$15,000/asset class/active \$10,000/asset class/passive
Asset Allocation Studies	\$200 per hour
Investment Goals, Objectives and Policy Review	INCL. PERFORMANCE
Internal Investment Management Review	\$200 per hour
Research and Analysis	INCL. PERFORMANCE
Litigation	\$250 per hour
General Investment Consulting Services	INCL. PERFORMANCE
1 st Renewal Period 3% Maximum Increase	2 nd Renewal 6% Maximum Increase
3 rd Renewal Period 10% Maximum Increase	4 th Renewal 14% Maximum Increase

<i>Investment Consultant Functions</i>	<i>Callan Associates Fees</i>
Evaluation of Potential Investment Managers	\$18,000-30,000/Domestic Active Managers \$18,000-23,000/Passive/Index Managers \$25,000-35,000/International Active Managers \$30,000-35,000/Real Estate Separate Acct Managers \$30,000-45,000/Alternative Asset Class Managers
Asset Allocation Studies	\$35,000-45,000 per year
Investment Goals, Objectives and Policy Review	\$8,000-12,000 per year
Internal Investment Management Review	\$12,000-25,000 per year
Research and Analysis	\$0-\$12,000 per project
Litigation	\$2,500/day + travel exp.
General Investment Consulting Services	\$0-\$24,750 per year
1 st Renewal Period 6.8% Maximum Increase	2 nd Renewal Period 6.8% Maximum Increase
3 rd Renewal Period 6.8% Maximum Increase	4 th Renewal Period 6.8% Maximum Increase

Mr. Ray Rottas seconded the motion.

By a vote of 7 in favor, 0 opposed, 0 abstentions, 2 excused, the motion was approved.

7. Presentation, Discussion and Appropriate Action Regarding Emergency Repeal of Exhibit L of Rule 2-8-126 “Multiples of Pay Factors for Determining the Actuarial Liability of a Transferring Member’s Benefit” and Emergency Adoption of New Exhibit L of Rule 2-8-126 “Multiples of Pay Factors for Determining the Actuarial Liability of a Transferring Member’s Benefit”

Mr. Fred Stork reported that the increase in the multiplier benefits, from 2.0 percent to 2.1 percent, affects the value of the members’ benefits and the ASRS actuarial accrued liability. In order for the ASRS to fairly evaluate the benefits of member who are transferring out, and for the ASRS to meet

its statutory requirement to not incur any unfunded liability with a transfer in, the ASRS needs to use new factors for the valuation in connection with transfers. He recommended that the Board adopt the change in Exhibit L to Rule 2-8-126 so that the ASRS may discontinue the use of the factors adopted in 1993 and begin using the new factors immediately.

Motion: Dr. Merlin DuVal moved that the Board find that an emergency exists and compliance with the notice and public participation requirements of the administrative procedure act are impracticable, all as stated in the finding of emergency incorporated herein respecting Exhibit L to Rule R2-8-126; and move that Exhibit L to Rule R2-8-126 be and it hereby is repealed; and move that updated transfer factors in the form prepared and submitted to the ASRS by the ASRS' actuaries attached hereto be and they hereby are adopted as Exhibit L to Rule R2-8-126.

Mr. Karl Polen seconded the motion.

By a vote of 7 in favor, 0 opposed, 0 abstentions, 2 excused, the motion was approved.

8. Director's Report

Dr. Chuck Essigs reviewed a study by Watson Wyatt that recommends the ASRS and the State of Arizona address the problem of adverse selection in health insurance so that premiums are more affordable and cost is under control. Then the state might consider self-funding of health insurance. Mr. Bill Hickman from Watson Wyatt agreed that the adverse selection process is really the heart of the problem for the state. He noted that self-funding has modest savings on administrative costs, but the advantage of it is continuity, control over funding and benefit levels offered and control over providers.

Dr. DuVal cautioned again that changing the system to solve the problems of one group may adversely affect the options for the rest of the group. In addition, a self-funded system will be in competition with vendors that already have discounted services and the system may lose any cost savings. Mr. Hickman pointed out that self-funded systems can take advantage of the existing provider networks and administrative process; it just takes the risk away from them and puts it on the system.

9. Board requests for agenda items.

There were no requests for agenda items from Board members.

10. Call to the Public.

Mr. Ron Murphy of Phoenix suggested that Board members and staff refer to any benefit increases as permanent benefit increases (PBIs) rather than Cost of Living Adjustments (COLAs), since increases are determined based on the funds of the system rather than the cost of living.

Mr. Conrad Powell, of Maricopa Community College Retirees, thanked the Board and the administration for the opportunity to discuss the health insurance issue and procurement process with retiree organizations at a meeting scheduled for January 29, 2001.

Mr. Gale Richards congratulated the Board for discussing the short-term versus long-term solutions offered by the legislature and encourage the Board to ensure that whatever passes can be achieved.

There were no requests to speak from the Tucson public.

11. *Burke v. Arizona State Retirement System Et Al.* (Pima County Superior Court No. 316479). Discussion and Decision Concerning Appeal of Award of Attorneys' Fees.

Motion: Mr. Ray Rottas moved that the Board convene to Executive Session to discuss the *Burke v. ASRS* Lawsuit.

Mr. Jim Bruner seconded the motion.

By a vote of 7 in favor, 0 opposed, 0 abstentions, 2 excused, the motion was approved.

The ASRS Board convened to Executive Session at 10:20 a.m.

The Board reconvened to Regular Session at 10:48 a.m.

12. The next regular ASRS Board meeting is scheduled for Friday, February 16, 2001, at 8:30 a.m. in the 10th Floor Board Room of the ASRS office at 3300 North Central Avenue, Phoenix, Arizona 85067-3910.

13. Adjournment of the ASRS Board.

Dr. Chuck Essigs, Chairman, adjourned the January 19, 2001 regular meeting of the ASRS Board at 10:48 a.m.

Respectfully submitted,

Maurah Harrison, Secretary

Date

LeRoy Gilbertson, Director

Date